D. CURRENT ISSUES AFFECTING CERTAIN COOPERATIVES AND LIKE ORGANIZATIONS DESCRIBED UNDER IRC 501(c)(12)

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1. Introduction

The purpose of this article is to examine current issues affecting electric and telephone cooperatives and "like organizations" as they pertain to exemption under IRC 501(c)(12). Issues affecting benevolent life insurance companies, mutual ditch, and irrigation companies will not be addressed.

The article begins by summarizing the basic requirements for exemption under IRC 501(c)(12). It then addresses several issues bearing on the 85 percent member-income test. This is followed by an analysis of issues relating to the unreasonable accumulation of earnings. Lastly, the article discusses current legislative proposals to amend IRC 501(c)(12).

2. IRC 501(c)(12) Organizations

A. Basic Requirements for Exemption

IRC 501(c)(12) provides for the recognition of exemption from federal income tax of mutual or cooperative telephone companies, or like organizations; but only if 85 percent or more of the income consists of amounts collected from members for the sole purpose of meeting losses and expenses. Mutual or cooperative electric companies are considered to be "like organizations" for these purposes. Rev. Rul. 67-265, 1967-2 C.B. 205. While the statute uses the terms "mutual" and "cooperative" the Service has seen no necessity to differentiate between these terms for purposes of IRC 501(c)(12). Accordingly, this article will refer only to the term "cooperative."

Reg. 1.501(c)(12)-1(a) provides that an organization may be entitled to exemption if it makes advance assessments to meet future losses and expenses, provided that the balance of such assessments remaining on hand at the end of the year is retained to meet losses and expenses or is returned to members.

In the case of both electric and telephone cooperatives, the 85 percent test is applied without taking into account any income received or accrued from qualified pole rentals, or from the prepayment of a loan under section 306A, 306B, or 311 of the Rural Electrification Act of 1936 (as in effect on January 1, 1987). An additional exclusion from the 85 percent test is available to telephone cooperatives for the income they receive or accrue from a nonmember telephone company for the performance of communication services that involve members of the telephone cooperative.

A more detailed discussion of the exemption requirements under IRC 501(c)(12) can be found in the 1980 CPE starting at page 97.

3. The 85 Percent Test

A. Basic Requirements of the 85 Percent Test

The 85 percent test is designed to ensure that organizations exempt under IRC 501(c)(12) provide services at cost to their members. Accordingly, each year a cooperative's income, with certain modifications, is determined and the total amount received from members for the sole purpose of meeting losses and expenses must be at least 85 percent of the income.

The 85 percent test is applied on the basis of an annual accounting period. Failure to meet the requirement in a particular year precludes exemption for that year, but has no effect upon exemption for years in which the 85 percent test is satisfied. Rev. Rul. 65-99, 1965-1 C.B. 242. If an organization uses the accrual method of accounting, compliance with the 85 percent test must be determined under that method. Rev. Rul. 68-18, 1968-1 C.B. 271. See also the discussion of margin stabilization plans, 4.B. of this topic.

Calculation of the 85 percent test is illustrated by the following example contained in Reg. 1.501(c)(12)-1(c).

> If, in one year, a cooperative telephone company received \$85x from its members for telephone calls, \$15x as interest income, and \$20x as credits under long distance interconnection agreements with other telephone companies for the performance of communication services involving the completion of long distance calls to, from, or between the cooperative's members, the member-income fraction is calculated without taking into account either in the numerator or denominator, the \$20x credits received from the other telephone companies. In this example the 85 percent member-income test is satisfied because at

least 85 percent

$$\left(\frac{\textbf{member income}}{\textbf{total income}} = \frac{\mathbf{85x}}{\mathbf{85x + 15x}} = \frac{\mathbf{85}}{\mathbf{100}} = \mathbf{85\%}\right)$$

of the cooperative's total income is derived from member income.

The remainder of this section of the article will deal with recent developments involving the 85 percent test.

B. Treatment of Fees Received by Telephone Cooperatives for the Performance of Billing and Collection Services

As a result of the breakup of AT&T, the Federal Communications Commission (FCC) restructured the relationship between local telephone cooperatives, long distance companies and individual telephone subscribers. In restructuring the telephone industry, the FCC defined "billing and collection" for the first time. The FCC characterized "billing and collection" as a "financial and administrative service" rather than a "communication service" for purposes of Title II of the Communications Act of 1934. Detariffing of Billing and Collection Services, 102 F.C.C.2d 1150 (1986).

In TAM 91-11-001 (March 15, 1991) the Service followed the FCC's lead in characterizing the fees received by telephone cooperatives for "billing and collection" services. The TAM concluded that, although telephone cooperatives receive "billing and collection" income from long distance telephone companies, that income is not received for the performance of "communication services" within the meaning of IRC 501(c)(12)(B)(i). Therefore, the income is not excludable from the 85 percent test. Rather, "billing and collection" is a business service performed by telephone cooperatives for nonmembers (i.e., the long-distance telephone companies) and constitutes nonmember income for purposes of the 85 percent test. Moreover, because "billing and collection" is unrelated to providing "communication services" by the telephone cooperative to its members, the income is subject to tax as unrelated business taxable income.

On May 8, 1992, the FCC released a decision in which it reversed its position regarding the characterization of billing and collection services. Policies and Rules Concerning Local Exchange Carrier Validation and Billing Information for Joint Use Calling Cards, CC Docket No. 91-115, FCC 92-168. In the course of concluding that telephone companies must file tariffs for the charges for validation of calling card numbers to long distance companies, the FCC recognized an inconsistency with its prior position regarding billing and collection. In so doing, it reversed itself and stated that, "...billing and collection is incidental to the transmission of wire communication and thus is properly considered a communications service under Section 3(a) of the Act..."

It is important to note that the FCC's decision did not purport to define "communication services" for purposes of IRC 501(c)(12). Accordingly, despite the change in the FCC's position, the Service continues to view "billing and collection" as a business service performed by telephone cooperatives for nonmembers. The Service announced this position in Notice 92-33, 1992-30 I.R.B. 15, which states that for tax years beginning after December 31, 1990, the Service will follow the position taken in TAM 91-11-001.

The 103rd Congress is considering three bills which, if passed, would reverse the result reached in TAM 91-11-001. They are S.155, H.R. 614, and H.R. 778. These bills would exclude income received or accrued from billing and collection services performed for a nonmember telephone company from the calculation of the 85 percent test. However, each of the bills specifies that no inference should be made as to the proper treatment of the billing and collection income for purposes of the tax on unrelated business income.

C. Treatment of Discharge of Indebtedness Income Arising From the Prepayment of Certain Loans

On October 21, 1986, Congress passed the Omnibus Budget Reconciliation Act of 1986 (OBRA). OBRA amended the Rural Electrification Act of 1936 (REA Act) to permit electric and telephone cooperatives to prepay loans made under the REA Act at significant discounts. The ability to prepay loans under this authorization expired on September 30, 1987.

To the extent that the prepayment of the REA loans resulted in the forgiveness of existing obligations, a cooperative would be considered to have received income from the discharge of indebtedness. Realizing that loan prepayments under this authorization could result in nonmember income of at least 15 percent, Congress amended IRC 501(c)(12)(B) and (C) to provide that in the case of electric and telephone cooperatives, the 85 percent test would not take into account income received or accrued from the prepayment of a loan under the REA Act (as in effect on January 1, 1987). While this exclusion from the 85 percent test is still contained in the Code, it has no effect because the prepayment opportunity arising under the REA Act expired on September 30, 1987. Moreover, this exclusion cannot be interpreted to apply to any subsequent loan prepayment authorizations.

A second, non-Code provision, was enacted as section 6203 of the Technical and Miscellaneous Revenue Act of 1988. This provision was not restricted to electric or telephone cooperatives or to financing from the Rural Electrification Administration. The provision stated that the discount earned from the prepayment of any loan made or guaranteed by the U.S. Government by an IRC 501(c)(12) organization would be excluded from the 85 percent test if cancellation of debt occurred after December 31, 1986, and before January 1, 1990. Like the provision relating to REA loans, this more general opportunity to exclude discharge of indebtedness income from the 85 percent test lapsed and has no effect for taxable years after December 31, 1989.

At this time, there is no legislation or other authority in effect which would enable cooperatives to exclude discharge of indebtedness income arising from the prepayment of REA loans or other U.S. Government loans from the 85 percent test. Therefore, discharge of indebtedness income arising from the prepayment of such loans must be included in the calculation of the 85 percent test as nonmember income.

D. <u>Gross Receipts v. Gross Income</u>

Prior to 1977, the Service applied the 85 percent test to electric cooperatives on the basis of gross receipts under the rationale contained in G.C.M. 33398 (Dec. 28, 1966). The reasoning was that, while income means gross income, electricity is a noninventoriable item. Therefore, there is no cost of goods sold component to subtract from gross receipts.

Subsequently, G.C.M. 37199 (July 25, 1977) was issued which provided that gross income from the sale of electricity is determined by subtracting the cost of production from gross receipts. This G.C.M. further provided that the costs incurred in the production of electricity are in fact the cost of goods sold. Therefore, electricity should be regarded as an item of inventory.

In an attempt to clarify its position on this issue, the Service issued Prop. Reg. 1.501(c)(12)-2(b), 49 Fed. Reg. 1244 (1984). The proposed regulations provided that for purposes of applying the 85 percent test to electric cooperatives, the term "income" meant gross income. Under the proposed regulations, gross income would have been determined by subtracting the cost of goods sold from gross receipts. The cost of goods sold was to be determined under Reg. 1.471-11 (relating to the full absorption method of inventory costing) and electricity would have been treated as an inventoriable item for purposes of applying Reg. 1.471-11.

Clearly, it would have been more difficult for electric cooperatives to meet the 85 percent test under the proposed regulations. However, in an effort to eliminate unnecessary regulatory burdens, the Service withdrew the proposed regulations on April 27, 1993, 58 Fed. Reg. 25587 (1993). Accordingly, until a final decision is announced, electric cooperatives may use either the gross receipts or gross income method. However, as indicated in the recently withdrawn proposed regulations, they should continue to use the method they have consistently applied in the past.

E. Elections Under IRC 266

An election under IRC 266 can make or break a cooperative's ability to satisfy the 85 percent test in a particular year.

Under IRC 266, taxpayers may elect to capitalize into the adjusted basis of property certain taxes and carrying charges (including interest) that are chargeable to capital accounts, notwithstanding that these costs are otherwise deductible under other provisions of the Code. Under Reg. 1.266-1(c)(3), the election is exercised by filing with the taxpayer's original return for the year in which the election is made a statement indicating the item or items that the taxpayer is electing to capitalize.

As an illustration of the impact of an election under IRC 266 on a cooperative's ability to satisfy the 85 percent test, consider an electric cooperative that elects to capitalize the interest on debt that it incurs to finance the construction of a plant. Once the election is made, the cooperative must continue to capitalize the interest until the project is completed. If the cooperative subsequently sells the plant, gain on the sale will be nonmember income, and may cause the organization to fail the 85 percent test in a particular year. In this example, an election under IRC 266 would benefit the cooperative because adding the interest expense to the cooperative's basis in the plant would reduce the amount of gain realized upon disposition of the plant.

An election under IRC 266 may also work against a cooperative that is recognized as exempt under IRC 501(c)(12). An IRC 501(c)(12) cooperative can go in and out of exemption on an annual basis due to fluctuations in its member income. If the cooperative makes the election under IRC 266 to capitalize interest on a loan to build a plant, and then fails the 85 percent test in a particular year, making its income taxable for that year, it would not be able to deduct the interest on the loan. This result occurs because the election to capitalize the interest is binding for the duration of the project.

F. Treatment of Income Received By an Electric Cooperative's Wholly Owned Cable or Satellite Television Subsidiary

Recently, the National Office has received applications for exemption under IRC 501(c)(12) from cable and satellite television companies that are wholly owned by electric cooperatives. Consideration of these cases raised concern as to the proper treatment of the income received by an electric cooperative's wholly owned cable or satellite television subsidiary for purposes of applying the 85 percent test to the parent electric cooperative.

In Rev. Rul. 83-170, 1983-2 C.B. 97, the Service ruled that an organization furnishing cable television services to its members qualified for exemption under IRC 501(c)(12) as a like organization because it provided a public utility type service. This ruling should also be available to organizations providing satellite television services on a cooperative basis because the provision of satellite television is a public utility type of service. Moreover, except for the technology used to transmit television signals, no substantial differences exist between the operations of a cable television provider and a satellite television provider.

In analyzing the proper treatment of the income received by a subsidiary cable or satellite television company for purposes of applying the 85 percent test to the parent electric cooperative, guidance can be found in Rev. Rul. 69-575, 1969-2 C.B. 134. This revenue ruling provides, in part, that an IRC 521 cooperative may establish and control a subsidiary corporation so long as the subsidiary's activities are activities that the cooperative may engage in as an integral part of its operations without affecting its exempt status. Rev. Rul. 69-575 also indicates that the subsidiary's income should be included with the cooperative's income in order to determine whether the 15 percent test is satisfied.

Based on Rev. Ruls. 83-170 and 69-575, the income a subsidiary cable or satellite television company receives from monthly program service charges to those of its subscribers who are members of the electric cooperative would be treated as member income to the parent electric cooperative. However, such income received by the subsidiary from those subscribers who are not members of the electric cooperative would be treated as nonmember income to the parent electric cooperative for purposes of the 85 percent test. This holds true regardless of whether the subsidiary cable or satellite television company actually distributes its income to the parent electric cooperative.

An additional issue presented by subsidiary cable and television companies arises when the parent electric cooperative holds the voting rights to the cable or satellite company to the exclusion of the parent's member-patrons. In this situation, the cable or satellite television subsidiary cannot be recognized as exempt under IRC 501(c)(12) because it fails to meet the cooperative principle set forth in Rev. Rul. 72-36, 1972-1 C.B. 151, Question 1, which provides that the rights and interests of members in the organization must be determined in proportion to their business with the organization.

4. Unreasonable Accumulation of Earnings

A. 2 Percent and 5 Percent Loans

On May 23, 1991, The Wall Street Journal reported on circumstances which highlight the reasons behind President Clinton's proposal to eliminate the REA's 2 percent and 5 percent loan program. While these loans are intended to subsidize the cooperatives that provide electricity and telephone services to rural areas, it appears that some telephone cooperatives have used these loans to enrich themselves to a point which may affect their exempt status under IRC 501(c)(12). The article describes two telephone cooperatives that have accumulated millions of dollars in cash accounts and marketable securities. The funds have been accumulated through a variety of high yielding investments financed by the REA loan program. The article also indicated that the cooperatives were generating substantial amounts of income from network access charges and long distance toll revenues.

Rev. Rul. 72-36 discusses certain requirements that cooperatives must satisfy in order to be exempt under IRC 501(c)(12). This ruling states that funds can be retained in excess of those needed to meet the current losses and expenses for purposes such as retiring indebtedness incurred in acquiring assets, expanding the services of the organization, or maintaining reserves for necessary purposes. However, such funds may not be accumulated beyond the reasonable needs of the organization's business. Whether there is an improper accumulation of funds depends upon the particular circumstances of each case.

If the telephone cooperatives discussed in the article and other similarly situated cooperatives have accumulated funds beyond the reasonable needs of their business, they have failed to meet the requirements of Rev. Rul. 72-36. In such a situation, revocation of exemption would be required. Additionally, it would appear that cooperatives with such large reserves would have difficulty meeting the 85 percent test in light of the substantial investment income generated by the reserves.

B. Margin Stabilization Plans

(1) Background on Margin Stabilization Plans

On November 7, 1988, the REA published an Advance Notice of Proposed Rulemaking outlining the procedures that rural electric cooperatives must follow to receive REA approval of their margin stabilization plans. 7 C.F.R. sec. 1718 (1988). Under section 1718.68(a)(4) of the proposed regulations, a cooperative is required to submit a resolution from its board of directors indicating that margins will be allocated based on current operating performance absent any effects of a margin stabilization plan. This section provides further that in lieu of the board resolution, the cooperative must seek and obtain a private letter ruling from the Service addressing the effect of the margin stabilization plan on the cooperative's exempt status and its continued operation as a cooperative.

The National Office has received relatively few private letter ruling requests from cooperatives seeking approval of their margin stabilization plans. However, the Service is aware that many cooperatives have adopted and are currently using margin stabilization plans. These plans are intended to enable electric cooperatives to use accounting procedures that allow them to defer taking into account certain current revenues or expenses until future periods in order to make future rate adjustments more uniform.

Cooperatives which adopt margin stabilization plans establish a "target margin." The target margin is an amount by which revenues are budgeted to exceed expenses. Under such a plan, a cooperative will report a margin of income over expenses equal to its target, regardless of the actual operating results. If the actual margin in a particular year exceeds the target margin, the surplus will be deducted from current income and recorded as a deferred credit. A deficit in the target margin will be added to current income and recorded as a deferred charge. The cash equivalent of all deferred credits is segregated into a stabilization fund until such time as an equal amount of deferred charges are applied against revenues.

(2) Exemption Issues Raised by Margin Stabilization Plans

a. Accumulation of Unreasonable Reserves

Cooperatives can make advance assessments to cover future expenses. Reg. 1.501(c)(12)-1(a); Question 2 of Rev. Rul. 72-36. However, the accumulation of unreasonable reserves is a clear indication that an organization is not operating in accordance with the accepted cooperative principle of operation on a nonprofit basis at the lowest possible cost. Accordingly, the cooperatives that have received private letter rulings from the Service approving their margin stabilization plans have represented that income deferred under the margin stabilization plan will be applied to meet losses and expenses or returned to members on the basis of their patronage within five years from the date such revenues are deferred.

b. Allocating Retained Assets to Current Members

Consistent with mutual and cooperative principles, a cooperative must account for its surplus funds that are not used to meet current expenses in such a manner as to allocate such funds to its members on the basis of their patronage. See Question 2, Rev. Rul. 72-36. An organization must also keep such records as are necessary to determine at any time each member's rights and interest in the retained assets in order to maintain its mutual or cooperative character. See Question 3 of Rev. Rul. 72-36. Strict compliance with Rev. Rul. 72-36 is required. Consequently, cooperatives must maintain records for purposes of determining each member's rights and interests in the cooperative's assets, including reserves set aside under a margin stabilization plan. Moreover, cooperatives seeking approval of their margin stabilization plan by the Service have been required to make certain disclosures to their members. They have been required to disclose the operation of their margin stabilization plan to their member patrons through the annotation of their financial statements, publication in newsletters, and the publication and distribution of special notices at their annual meeting.

c. Compliance With the 85 Percent Test

The use of a margin stabilization plan should not affect the 85 percent test. However, because margin stabilization plans enable electric cooperatives to defer revenues and expenses from one year to subsequent years, the use of such plans could result in the erroneous calculation of member income. Therefore, it must be emphasized that cooperatives may not use margin stabilization plans to defer taking into account any portion of their income for purposes of the 85 percent test.

5. Legislative Proposals to Amend IRC 501(c)(12)

There are several proposed changes to the 85 percent test pending in Congress. Aside from the proposal to change the treatment of billing and collection income discussed above, S.155, H.R. 614, and H.R. 778 all contain provisions under which 50 percent of the income received or accrued by a telephone cooperative from a nonmember telephone company for the performance of communication services by the telephone cooperative would be treated as member income for purposes of the 85 percent test. Presumably, the remaining 50% would be excluded from the computation.

Another amendment contained in both S.155 and H.R. 778 provides, generally, that in the case of a telephone cooperative the 85 percent test is applied without taking in account "reserve income" if such income, when added to other income not collected from members for the sole purpose of meeting losses and expenses, does not exceed 35 percent of the company's total income. Both bills define "reserve income" to mean income which is derived from assets that are set aside for the repair or replacement of the telephone system facilities of the cooperative. Under both of these proposals IRC 512 would also be amended to include reserve income within the definition of unrelated business taxable income to the extent that any reserve income, when added to other income not collected from members for the sole purpose of meeting losses and expenses, exceeds 15 percent of the cooperative's total income.

6. Conclusion

As illustrated by the discussions relating to the treatment of fees received for billing and collection services, REA loans, and margin stabilization plans, the Exempt Organization Specialist must strive to stay abreast of the programs and positions taken by other government agencies, that are involved in the regulation of electric and telephone cooperatives, while maintaining a sharp focus on the requirements for exemption under IRC 501(c)(12).